GENERAL FUND REVENUE UPDATE
FISCAL 2008

A Report Prepared for the
Legislative Finance Committee

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INTRODUCTION

The purpose of this report is to provide the committee with current information on general fund revenue collections through February 2008. The 2009 biennium outlook table that would be traditionally included in the report has not been updated. The reason for not showing a detailed 2009 biennium outlook table is because considerable research and analysis will be required to determine whether the revenue trends observed in fiscal 2007 as well as in fiscal 2008 will continue throughout the 2009 biennium. In addition to the revenue side of the financial picture, staff continues to monitor and assess the need for supplemental funding in major functional areas.

During the regular legislative session, our office recommended to the 60th Legislature that the general fund revenue estimates be increased by $63.7 million for fiscal 2007. Because it was unclear what economic conditions were driving the additional revenue, no adjustments to the 2009 biennium revenue estimates were recommended. The 60th Legislature did not adjust their revenue estimates to include the $63.7 million for fiscal 2007. The additional revenue was anticipated from two major sources, individual and corporation income taxes. The final collections for fiscal 2007 showed that total general revenues exceeded the legislature's estimate by $61.2 million. Both individual and corporation income tax exceeded estimates. As explained later in this report, fiscal 2008 individual income tax collections are exceeding estimates while corporation income tax collections are lagging behind estimates. The information in this report is based on data received through the end of February 2008.

The report is organized into three main sections. The first section discusses the fiscal 2008 general fund revenue collections including a discussion of selected general fund revenue sources. The second section addresses key economic trends that help understand or explain why selected revenue sources fluctuate from legislative estimates. The third section discusses major fiscal issues that have the potential of impacting the general fund balance.

GENERAL FUND REVENUE OUTLOOK

FISCAL 2008 REVENUE TRENDS

Based on information recorded through the end of February 2008 on the Statewide Accounting, Budgeting, and Human Resource System (SABHRS), total general fund receipts for fiscal 2008 were $1.024 billion as shown in Figure 1. This compares to $963.0 million collected for the same period of fiscal 2007. Total general fund collections are $60.6 million above last year's amount, which represents a 6.3 percent increase. Revenue estimates as used by the 60th Legislature and contained in HJ 2 (revenue estimate resolution) assumed collections would decline $60.0 million or 3.3 percent from fiscal 2007 to 2008. Most of this reduction was expected from individual and corporation income taxes. Individual income tax collections were expected to decline partly because of tax credits authorized in HB 9 of the May 2007 special session and the additional one percent capital gains credit authorized in SB 407 of the 2003 session. Corporation income tax collections were expected to decline because audit revenue is expected to abate from the historic level observed in fiscal 2007.

Figure 1 shows revenue collection and estimate data by major revenue category. The last two columns in the figure show how the collections from the revenue source are performing when compared to the estimate contained in HJ 2. For example, insurance tax (2nd line) shows -13.44 percent in the "% Change" column. This means that collections through February 2008 are 13.44 percent less than collections through February 2007. The last column shows what the legislature assumed the growth rate would be (1.71 percent). Since the current growth rate through February (-13.44 percent) is less than the assumed growth rate (1.71 percent), insurance tax collections are lagging the estimate contained in HJ 2. Obviously, this is the conclusion based on collections data through February. However, a year to date snapshot does not necessarily identify a trend and this process must be done monthly to accurately monitor revenue collection trends.

Figure 1

General Fund Revenue Monitoring Report							
Revenue Source	Actual Fiscal 2007	HJ2 Estimate Fiscal 2008	Through 2/28/07	Through 2/29/08	Difference	% Change	HJ2 Estimate % Change
GF0100 Drivers License Fee	4,610,686	3,952,000	2,375,055.85	2,480,823.79	105,767.94	4.45%	-14.29%
GF0200 Insurance Tax	61,074,266	62,121,000	25,862,229.46	22,386,718.94	(3,475,510.52)	**-13.44%**	1.71%
GF0300 Investment Licenses	6,094,903	6,451,000	5,007,499.08	5,478,721.00	471,221.92	9.41%	5.84%
GF0400 Vehicle License Fee	98,070,390	109,028,000	56,712,435.73	54,399,267.45	(2,313,168.28)	**-4.08%**	11.17%
GF0500 Vehicle Registration Fee	18,404,506	9,607,000	9,163,872.20	11,942,422.28	2,778,550.08	30.32%	-47.80%
GF0600 Nursing Facilities Fee	5,716,793	5,781,000	3,335,226.75	2,792,396.60	(542,830.15)	**-16.28%**	1.12%
GF0700 Beer Tax	3,034,266	2,965,000	1,765,811.87	1,844,075.56	78,263.69	4.43%	-2.28%
GF0800 Cigarette Tax	35,829,932	33,843,000	22,549,897.66	23,222,732.78	672,835.12	2.98%	-5.55%
GF0900 Coal Severance Tax	10,919,266	9,864,000	5,567,752.71	6,058,570.63	490,817.92	8.82%	-9.66%
GF1000 Corporation Tax	177,503,707	161,271,000	95,975,049.98	74,449,331.32	(21,525,718.66)	**-22.43%**	-9.14%
GF1100 Electrical Energy Tax	4,564,404	4,798,000	2,293,865.63	2,721,854.54	427,988.91	18.66%	5.12%
GF1150 Wholesale Energy Trans Tax	3,651,024	3,827,000	1,837,907.90	1,924,750.86	86,842.96	**4.73%**	4.82%
GF1200 Railroad Car Tax	1,614,509	1,567,000	1,127,456.48	1,524,197.55	396,741.07	35.19%	-2.94%
GF1300 Individual Income Tax	827,145,498	766,566,000	466,219,570.91	514,108,808.65	47,889,237.74	10.27%	-7.32%
GF1400 Inheritance Tax	838,865	310,000	195,839.08	87,285.11	(108,553.97)	-55.43%	-63.05%
GF1500 Metal Mines Tax	8,991,415	9,613,000	(0.03)	2,326.88	2,326.91	**#########**	6.91%
GF1700 Oil Severance Tax	96,334,992	101,235,000	25,513,897.06	29,480,096.10	3,966,199.04	15.55%	5.09%
GF1800 Public Contractor's Tax	5,566,958	3,417,000	4,848,388.62	3,423,466.67	(1,424,921.95)	-29.39%	-38.62%
GF1850 Rental Car Sales Tax	2,976,235	3,000,000	1,753,844.95	1,855,465.06	101,620.11	5.79%	0.80%
GFxxxx Property Tax	190,981,940	198,117,000	105,935,592.15	113,084,250.86	7,148,658.71	6.75%	3.74%
GF2150 Lodging Facilities Sales Tax	12,916,075	11,881,000	6,719,379.42	7,537,160.15	817,780.73	12.17%	-8.01%
GF2200 Telephone Tax	-	-	-	-	-		
GF2250 Retail Telecom Excise Tax	21,065,843	21,298,000	6,174,947.61	10,153,337.55	3,978,389.94	64.43%	1.10%
GF2300 Tobacco Tax	4,669,627	4,385,000	2,782,566.25	2,818,070.60	35,504.35	1.28%	-6.10%
GF2400 Video Gaming Tax	60,641,063	63,649,000	29,978,540.78	31,953,975.83	1,975,435.05	6.59%	4.96%
GF2500 Wine Tax	1,774,838	1,798,000	1,057,630.94	1,106,278.40	48,647.46	4.60%	1.31%
GF2600 Institution Reimbursements	10,669,017	13,507,000	4,450,217.55	6,739,968.28	2,289,750.73	51.45%	26.60%
GF2650 Highway Patrol Fines	4,155,144	4,974,000	2,447,162.20	2,345,749.85	(101,412.35)	**-4.14%**	19.71%
GF2700 TCA Interest Earnings	33,951,447	21,546,000	17,952,532.18	21,430,241.94	3,477,709.76	19.37%	-36.54%
GF2900 Liquor Excise Tax	13,981,692	14,573,000	8,311,410.69	8,906,560.81	595,150.12	7.16%	4.23%
GF3000 Liquor Profits	8,200,000	7,907,000	-	-	-		-3.57%
GF3100 Coal Trust Interest Earnings	32,334,879	29,916,000	15,335,567.53	13,831,972.91	(1,503,594.62)	**-9.80%**	-7.48%
GF3300 Lottery Profits	11,420,242	8,794,000	2,714,849.00	2,778,754.00	63,905.00	2.35%	-23.00%
GF3450 Tobacco Settlement	2,861,266	3,855,000	25,073.79	-	(25,073.79)	**-100.00%**	34.73%
GF3500 U.S. Mineral Leasing	28,220,719	31,694,000	13,741,098.42	17,160,741.35	3,419,642.93	24.89%	12.31%
GF3600 All Other Revenue	19,085,412	32,793,000	13,285,235.45	23,634,665.22	10,349,429.77	77.90%	71.82%
Grand Total	1,829,871,819	1,769,903,000	963,017,405.85	1,023,665,039.52	60,647,633.67	6.30%	-3.28%

The total shown at the bottom of Figure 1 indicates that general fund revenue growth for fiscal 2008 (6.3 percent) may be above expectations since total revenues were expected to decrease by 3.3 percent from actual fiscal 2007 collections. If the current growth rate were to continue at the same level for the remainder of the year, the revenue estimate contained in HJ 2 would be exceeded. Estimated collections for fiscal 2008 are from HJ 2 as introduced during the 60th Legislature adjusted for revenue legislation enacted by the regular and special sessions.

While the growth rate of 6.3 percent is above the adjusted HJ 2 estimated rate of a negative 3.3 percent, there can be unusual events occurring between fiscal years that make an aggregate comparison of this type misleading. For example, if collection patterns during the past year are not similar to the current year, the computed growth rate can be skewed either positively or negatively. Unusual or one-time collections such as audit activity in either year can also distort the underlying growth rates. Both individual and corporation income tax collections can be significantly influenced by audit efforts of the Department of Revenue.

DISCUSSION OF SELECTED REVENUE SOURCES FOR FISCAL 2008

As explained in the previous section of the report, a comparison of total revenues from the previous fiscal year to the current fiscal year can be misleading. Not only can collection patterns and statutory modifications change revenue trends, but changes in general economic conditions can also skew aggregate growth trends.

Figure 2

Comparison of Selected Revenue Sources to Adjusted HJ2 Estimates			
Revenue Source	Actual Fiscal 2007	HJ2 Estimated Fiscal 2008	Estimated Chg From 2007
Individual Income Taxes	827,145,498	766,566,000	(60,579,498)
Corporation Income Taxes	177,503,707	161,271,000	(16,232,707)
Property Taxes	190,981,940	198,117,000	7,135,060
Natural Resource Taxes & Royalties	144,466,392	152,406,000	7,939,608
Vehicle Taxes	116,474,896	118,635,000	2,160,104
Totals	$1,456,572,433	$1,396,995,000	($59,577,433)

As shown in Figure 2, the five general fund revenue sources listed comprised almost eighty percent of the total general fund collections received in fiscal 2007. These sources were expected to decrease by $59.6 million from fiscal 2007 actual collections. Included in this amount is an anticipated reduction in individual income tax revenues of $60.6 million. This decrease is expected because of the phased-in impacts of SB 407 (income tax reform) of the 58th Legislature and tax credit legislation enacted in HB 9 of the May 2007 special session. The legislature also expected corporation income tax collections to decrease by $16.2 million from the fiscal 2007 amount. This reduction is anticipated because audit collections are expected to abate from the record levels observed during fiscal 2007. The legislature also expected property taxes to increase $7.1 million reflecting the expected increase in statewide taxable values. The legislature also expected natural resource taxes (oil, natural gas, coal, metals, and royalties) to increase by $7.9 million. This increase was predominately due to higher production levels anticipated for oil. Vehicle taxes were expected to increase by $2.2 million.

The following section of the report addresses selected revenue sources whose estimated fiscal 2008 collections may be significantly different than estimated by the 60th Legislature. Also discussed are sources of revenue that our office is monitoring closely for potential differences in the collections versus the estimates included in HJ 2.

Individual Income Tax

Based on accounting data through February 2008, individual income tax collections for fiscal 2008 are exceeding estimates contained in HJ 2. Net collections (gross collections less refunds) through February 2008 were 10.3 percent above net collections through February 2007 or an increase of $47.9 million. The 60th Legislature assumed the growth rate to be a negative 7.3 percent from the fiscal 2007 amount or a decline of $60.6 million. As previously mentioned, this decline was anticipated because of the effects of SB 407 of the 58th Legislature and HB 9 of the May 2007 special session.

It is not totally clear whether these trends will continue throughout the entire fiscal year. Since about 60 percent of total income reported on state tax returns reported for tax year 2006 was from wage and salary income, a review of this income component may provide some insight to future collection patterns. As assumed in HJ 2, the wage and salary growth rate between calendar years 2006 and 2007 was estimated to be 4.9 percent. According to the Bureau of Economic Analysis (BEA) preliminary data (shown in Figure 6 based on three quarters) indicate growth was 8.2 percent or 4.5 percentage points above the assumed rate shown in HJ 2.

Figure 3 shows the accounting details of individual income tax collections through February of this year compared to the same period of fiscal 2007. Since withholding tax collections could be a proxy of total wage growth, the 9.2 percent growth above last year would indicate wages may be growing even faster than the BEA data would suggest. However, total refund amounts are greater than last year by 13.2 percent. Higher refunds could be partially explained by the effects of the tax credits authorized by HB 9 of the May special session. This is because the credits will be claimed on a taxpayer's return filed beginning January 2008. Since these credits will reduce a taxpayer's liability, either refunds will be higher or tax return payments will be reduced accordingly. It should be noted, however, a majority of refunds are issued during the March through May time period. Also, it is unknown whether taxpayers will adjust their estimated payments for the additional capital gains credit authorized in SB 407. Such actions would mean that taxpayers would pay estimated payments at too high a rate this year with a corresponding increase in refunds for fiscal 2009.

Figure 3

Individual Income Tax Comparison				
	Through 2/28/07	Through 02/29/08		Percent
Revenue Code & Description	Fiscal 2007	Fiscal 2008	Difference	Change
510101 Withholding Tax	374,180,106.88	412,012,204.73	37,832,097.85	9.18%
510102 Estimated Tax	148,293,069.97	160,702,793.52	12,409,723.55	7.72%
510103 Current Year I/T	10,621,161.16	17,137,777.80	6,516,616.64	38.02%
510105 Income Tax - Audit Collections	14,913,052.33	18,464,165.00	3,551,112.67	19.23%
510106 Income Tax Refunds	(81,787,819.43)	(94,208,132.40)	(12,420,312.97)	13.18%
Totals	$466,219,570.91	$514,108,808.65	$47,889,237.74	10.27%
Percent of Actual/Estimated	56.36%	64.06%		

Figure 3 also shows that current year payments are above last year's amount by 38.0 percent or $6.5 million. Estimated payments are above last year's amount by 7.7 percent or $12.4 million. Estimated payments, and to some degree current year payments, reflect tax liability on non-wage components of income. Some examples of these components would be interest earnings, dividends, capital gains/losses, royalties, and net business income. Since estimated and current year payments, when combined, are above last year's amount, then one or several of the non-wage components of income are probably experiencing stronger growth than estimated in HJ 2.

Figure 3a

Individual Income Tax Income Categories Reported Amounts versus Estimate				
Income Category	Actual Tax Year 2006	Estimate Tax Year 2006	Dollar Change	Percent Change
Wages	11,779,591,544	11,870,074,018	(90,482,474)	-0.77%
Interest	636,780,024	517,789,426	118,990,598	18.69%
Dividends	521,733,730	514,861,484	6,872,246	1.32%
Net Business Income	785,303,056	761,019,619	24,283,437	3.09%
Capital Gains	2,006,020,579	1,554,054,359	451,966,220	22.53%
Supplemental Gains	67,793,383	76,401,556	(8,608,173)	-12.70%
Rental Income	1,944,998,907	1,877,179,749	67,819,158	3.49%
Farm Income	(176,145,427)	(153,598,246)	(22,547,181)	12.80%
Social Security	434,517,972	401,060,280	33,457,692	7.70%
IRA Income	339,908,795	330,669,565	9,239,230	2.72%
Pension Income	1,317,954,258	1,304,269,812	13,684,446	1.04%
Other Income	(49,247,766)	(63,332,757)	14,084,991	-28.60%
Totals	19,609,209,055	18,990,448,865	618,760,190	3.16%

Figure 3a shows a tabulation of reported income as accumulated for tax year 2006. As shown, total income reported was $618.8 million greater than estimated in HJ 2. A majority of this additional income was from interest income and net capital gains income. Based on recent actions of the FED, it would be reasonable to expect interest income to moderate, but probably not until tax year 2008.

Because the detailed tax schedules for capital gains are not captured electronically, it is impossible to determine what may be causing the growth in this income category. Obviously, property sales and the equity markets play a significant role in the generation of these gains. Based on equity market performance during the past year combined with the continuation of higher property sales during this same period, it seems reasonable to expect net capital gains income will show strong growth in tax year 2007. When all of the above factors are considered, fiscal 2008 individual income tax collections should be greater than the estimate contained in HJ 2.

Corporation Income Tax

Corporation income tax receipts for fiscal 2008 are below the estimate in HJ 2. Net collections (gross collections less refunds) through February 2008 were 22.4 percent or $21.5 million below the net collections through February 2007. The 60th Legislature assumed the growth rate to be a negative 9.1 percent or $16.2 million below the fiscal 2007 amount. Figure 4 shows specific details of corporation income tax collections through February of this year compared to the same period of fiscal 2007.

The weakness in collections could be explained by unusual high refund activity and the plight of the financial business sector. To date, refunds are significantly above last year when compared to the same period. The increase in refunds issued could be an indication that corporations overpaid their taxes in fiscal 2007 and are now claiming a refund when they filed their tax return in November. In reviewing monthly accounting data, almost eighty percent of the refunds issued occurred in November. This may also help explain why collections were greater than anticipated in fiscal 2007 (overpayment in fiscal 2007 with a corresponding refund request in fiscal 2008).

The financial sector of the US economy is struggling because of the weaknesses in the housing market and the impacts of subprime mortgages. Banks are extremely vulnerable to defaults and foreclosures which could result in significant losses. The corporation taxes paid by the financial sector could be much less this fiscal year when compared to last year. Conversely, increased prices for oil and natural gas continue to play a role in potentially higher corporation income tax revenues. To what degree the taxes paid by the natural resource sector offset the financial sector are unknown at this time. Our office has requested from the Department of Revenue a complete list of all corporation tax and refund payments during the period fiscal 2005 through year to date fiscal 2008. This data should help quantify the impacts.

Figure 4

Corporation Income Tax Comparison

Revenue Code & Description	Through 2/28/07 Fiscal 2007	Through 02/29/08 Fiscal 2008	Difference	Percent Change
510501 Corporation Tax	13,412,164.23	13,368,420.10	(43,744.13)	-0.33%
510505 Corporation Tax Estimated Paym	78,519,960.75	66,984,337.64	(11,535,623.11)	-14.69%
510502 Corporation Tax Refunds	(5,098,121.00)	(17,770,374.42)	(12,672,253.42)	248.57%
510503 Corporation Tax-Audit Collect.	9,141,046.00	11,866,948.00	2,725,902.00	29.82%
Totals	$95,975,049.98	$74,449,331.32	($21,525,718.66)	-22.43%
Percent of Actual/Estimated	54.07%	46.16%		

Other General Fund Revenue Sources

In general, almost all other general fund revenue sources are on target or exceeding the estimates contained in HJ 2. The four exceptions are insurance premiums taxes, nursing facilities fees, highway patrol fines, and coal trust interest earnings. Insurance premiums taxes, nursing facilities fees, highway patrol fines, and coal trust interest earnings all show collections lagging the HJ 2 estimate. Further research will be required to isolate the potential causes for the lagging receipts. Lagging highway patrol fine collections, however; are attributable to an incorrect fiscal note prepared during the 59th Legislature. These impacts have continued into fiscal 2008.

General Fund Revenue Categorization Issues

There are two issues that will impact the categorization of revenue collections in the 2009 biennium. The following explains each of these issues.

1. The State Auditor's Office is appropriated $4.4 million from the Medicaid Initiative account to reimburse general fund for lost income tax revenue due to tax credits for employers who provide health insurance to their employees. When the revenue estimates were prepared, it was assumed this revenue would be recorded as "all other revenue" and not as individual income taxes. Discussions with DOR staff indicate the money will be expended by the State Auditor's Office to the DOR and thus recorded as individual income tax revenue. This means the estimate for the "all other revenue" category is overstated by $4.4 million but the estimate for individual income tax is understated by a like amount.

2. Senate Bill 439 (2007 session) requires entities making royalty payments to royalty owners to withhold and remit to the DOR six percent of the royalty payment in quarterly payments beginning January 2008. It was anticipated that $1.5 million would be deposited to the general fund as individual income tax revenue in fiscal 2008. Since it is uncertain if taxpayers will apply the withholdings to individual or corporation income tax owed, the revenue will be recorded as "all other revenue". This means the estimate for the "all other revenue" category is understated by $1.5 million and the estimate for individual income tax is overstated by a like amount.

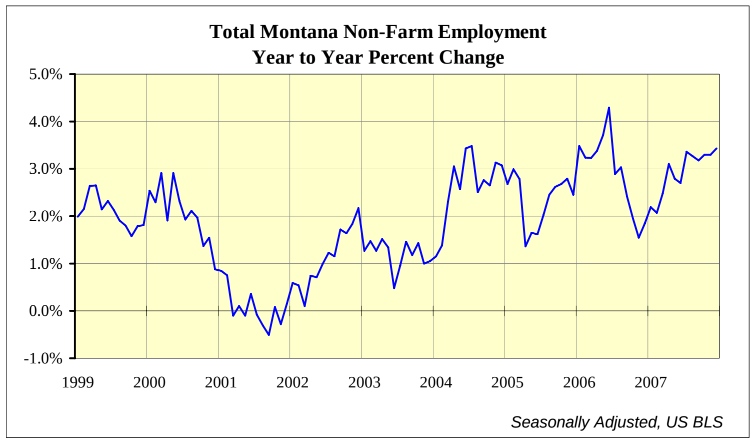
SIGNIFICANT ECONOMIC TRENDS

While the economic conditions in Montana continue to be strong, the US economy is showing signs of weakening. State government revenues are highly sensitive to factors such as Montana non-farm employment, wage and salary income, and various commodity prices such as oil, natural gas, coal, metals, livestock, and crops. Factors like corporate profitability, inflation factors, interest rates, equity markets, and federal tax changes are influenced by the national economy but have direct impacts on state revenues also. The following is a brief summary of current information that illustrates the impact of these economic factors on state revenues.

Montana Employment and Wages

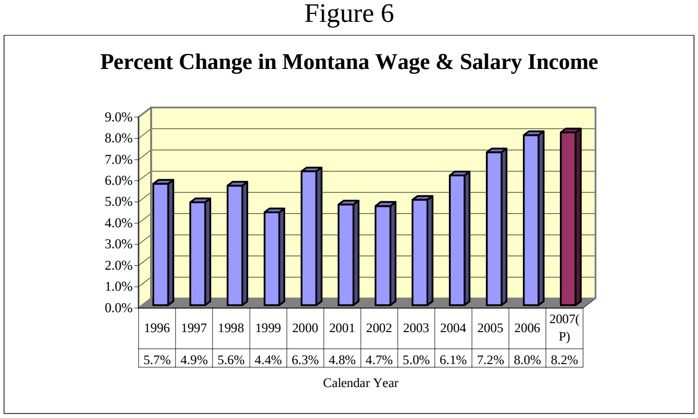
Statistics from the Bureau of Labor Statistics (BLS) continue to show strength in Montana's labor market. Preliminary estimates for non-farm payroll employment indicate that 14,900 new jobs were created between December 2006 and December 2007, an increase of 3.4 percent year over year. As seen in Figure 5, the velocity of growth diminished significantly from its peak in the middle of 2006, only to resume its pace through 2007. Much of the new growth can be credited to the construction industry, which in Montana continued to increase at a rate of 11 percent in 2007. Another industrial sector that experienced employment growth was the professional and business sector, where employment increased by 3,000 jobs, or 7.6 percent. Growth in employment is a key factor in estimating individual income taxes. The 3.4 percent growth rate, though currently a preliminary estimate, translates into strong wage and salary income growth (see Figure 6) and is a contributing factor in higher than expected individual income tax collections in fiscal 2008 (U.S. Department of Labor, Bureau of Labor Statistics Data, Detailed State and Metro Area Statistics).

Figure 5



In January, contrary to trends experienced in Montana, US employers cut 17,000 jobs from the economy. Economists had expected increases of 70,000 jobs in the month. However, some economists are suspicious of the numbers, suggesting that the figures could be revised soon. An example of how greatly revisions can change the preliminary estimates was apparent in December, when employment figures were revised from the reported gain of 18,000 jobs to a gain of 82,000 jobs. The unemployment rate for the month of January was 4.9 percent, slightly lower than the expected 5 percent. The weakening labor markets are a concern of economists, and the Federal Reserve credited these labor market concerns when announcing both of the recent rate cuts. (Job Shock: U.S. lost 17,000 in January, CNN Money, February 2008).

Figure 6



Montana wage and salary income continued to show strong growth in 2006. According to the Bureau of Economic Analysis, the actual growth for calendar 2005 to 2006 was 8.0 percent. Although final wage and salary data for calendar 2007 is not yet available, the growth in the first three quarters of calendar 2007 compared to the same period for calendar 2007 would indicate an annual growth rate of 8.2 percent (this rate is included in the figure above and denoted by 2007(P)). As seen in Figure 6, the current rate of growth in wage and salary income for 2007 has increased modestly from the calendar 2006 level. Furthermore, the preliminary 2007 growth rate is significantly above the rate of growth used in the HJ 2 projection for 2007, 4.9 percent.

Oil Prices and Production

The price of the West Texas Intermediate Crude (WTI) averaged $67.86 per barrel through November 2007. The monthly average WTI price has steadily increased since early 2003, reaching a high of $93.23 per barrel in November 2007 (December 2007 data are not available). The average difference between the price of WTI and Montana domestic crude price was $4.06 for data through November 2007. This difference, however, has increased significantly to $9.23 for October and $9.42 for November 2007.

Similarly, the price of Montana domestic crude oil price has remained high in 2007.

Figure 7

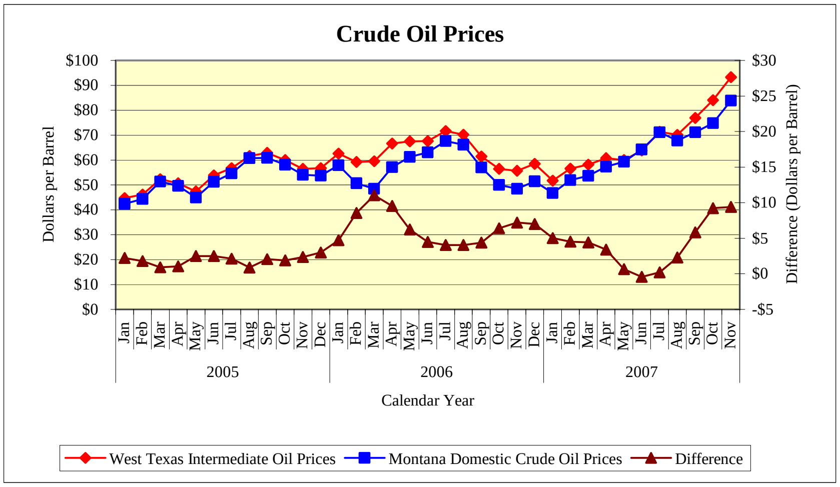
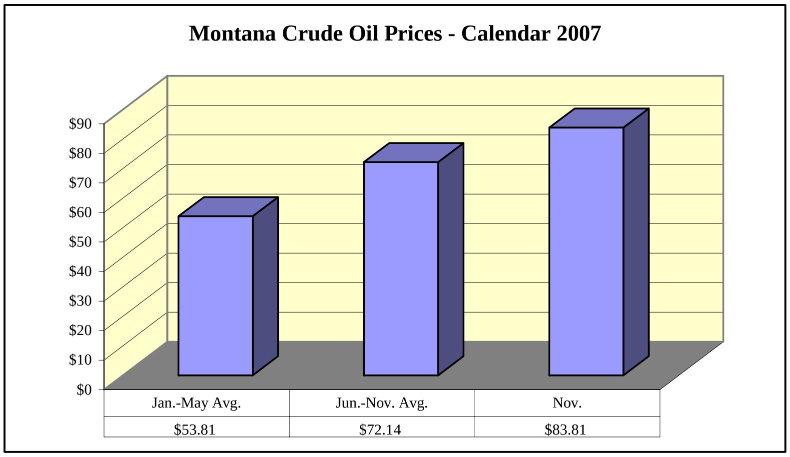


Figure 7a

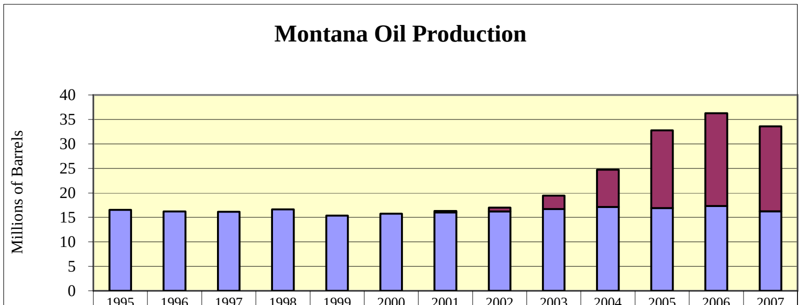


As shown in Figure 7a, the per-barrel price averaged $53.81 from January through May, increased to $72.14 per barrel from June to November, and reached a high in November of $83.81 per barrel. The average price of Montana domestic crude during calendar 2007 (January through November) was $67.86, which exceeded the assumed price of $53.15 used by the legislature in developing the estimate of oil production tax revenues in HJ 2.

While oil prices have been increasing, Montana's production has remained relatively stable until calendar 2003. Beginning in 2003, new production commenced with the development of the Bakken formation in the Elm Coulee field. As shown in Figure 7b, production from the Elm Coulee field has grown from 2.7 million barrels in 2003 to almost 19.0 million barrels in 2006. The Elm Coulee field now produces more oil than all the other fields combined in Montana.

The HJ 2 oil production estimates are based on the Elm Coulee production peaking in 2007 with subsequent years of production following a production decline curve patterned after other fields that use horizontal drilling technologies. New data from the Board of Oil and Gas web database, however, indicate that the Elm Coulee field peaked production in calendar 2006 and declined 1.6 million barrels from calendar 2006 to 2007. Depending on what happens with prices, oil production taxes may have peaked with the high probability of a declining revenue stream in the future assuming no new fields are discovered.

Figure 7b



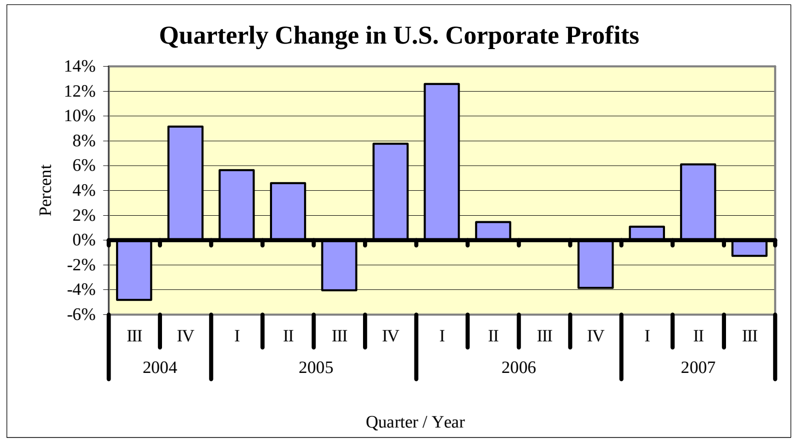
	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Elm Coulee	0.000	0.000	0.000	0.000	0.000	0.021	0.278	0.798	2.714	7.572	15.906	18.931	17.347
Other	16.525	16.184	16.163	16.648	15.351	15.740	16.011	16.192	16.706	17.147	16.880	17.323	16.228
Total	16.525	16.184	16.163	16.648	15.351	15.761	16.289	16.990	19.420	24.719	32.786	36.254	33.575

Calendar Year

Corporate Profits

The Bureau of Economic Analysis estimates that US corporate profits decreased $20.5 billion, or 1.3 percent (at a quarterly rate) in the third quarter of calendar 2007, after increasing 6.1 percent in the second quarter of 2007. Corporate profits were 1.8 percent higher in the third quarter of 2007 when compared to the third quarter of 2006. Growth in national corporate profits has shown signs of weakness, supporting national economists' contention that the country is moving towards an economic downturn (Corporate Profits, Bureau of Economic Analysis, Dec. 21, 2007).

Figure 8

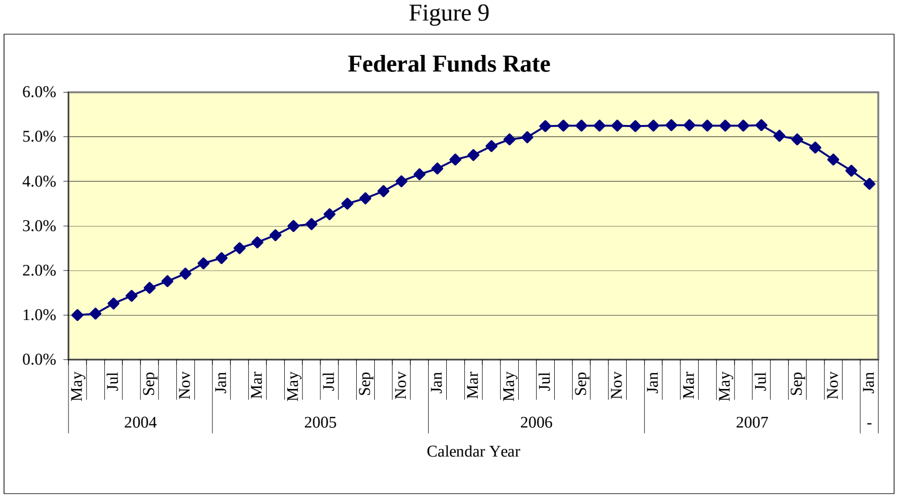


While Montana's corporation tax receipts do not strictly follow the national trend, the direction of change is often similar. When the nation experiences a recession (two quarters of negative growth in GDP), Montana corporation tax revenues tend to follow the trend. As shown in Figure 8, US corporate profits have been sluggish since the first quarter of calendar 2006. If the nation does enter a recessionary period, Montana's corporation tax revenues are expected to abate from the historic levels observed in fiscal 2007. Collection data through February show a weakening in collections as compared to the same period of last fiscal year.

Interest Rates

The federal funds rate, an overnight bank lending rate that influences what consumers pay on various types of loans, started to decline in August, 2007. The Federal Reserve cut the rate by a half-percentage point in September 2007 and a quarter-point cut followed in October. In the month of January, the average federal funds rate was 3.94 percent. A recent CNN Money article states that the Fed has steadily cut the federal funds rate to "help keep the economy from tipping into a recession". In January, the Fed cut rates twice by 1.25 percent in less than a month. According to the article, there is a growing consensus that the Fed will cut interest rates by another half percentage point in their March 18 meeting ("Bernanke vs. the Economy". CNNMoney, February 26, 2008).

Figure 9



Interest rates have a significant impact on all of Montana's trusts and interest bearing accounts. While lower rates help to lower the cost of debt service on state loans and bond issues, higher rates increase the revenues earned on many state investments. Montana is highly invested in bonds, and interest rates are one of the key components to determining investment revenue. However, the effect that falling interest rates may have on Montana's interest bearing accounts is both positive and negative. While earnings may decline as interest rates drop, to the extent that bonds may be sold at a premium, additional earnings may be realized. Lower interest rates can also reduce individual income tax collections. As shown in Figure 3a (individual income tax discussion), over $1.1 billion of interest and dividend income was reported on the individual income tax returns for calendar 2006. As interest rates decline, this income component may also decline.

FISCAL ISSUE WATCHLIST

As shown in the *Legislative Fiscal Report, Special Session September 2007*, the general fund ending fund balance for fiscal 2008 is projected to be $190.7 million. This balance is expected to drop to $125.0 million by the end of the 2009 biennium. This estimate is based on appropriations of the 60th Legislature (regular and special sessions) and includes the revenue estimates contained in HJ 2 and impacts of enacted legislation. If the revenue trends previously discussed continue for the remainder of the fiscal year, the general fund could end fiscal 2008 and 2009 with a balance greater than anticipated by the September special legislative session. However, these projected balances could change depending on the outcome of the fiscal issues listed in Figure 10 as well as others unforeseen at this time.

Figure 10

General Fund Balance
Fiscal Issues Watch List

Issue	Impact on Fund Balance	Biennial Impact Millions
$400 Rebate Reversion	Positive	$4.2
PPL Protested Tax Settlement	Positive	$2.3 plus
Federal Stimulus Package	Positive	Unknown
Board of Investments (SIV's)	Negative	Unknown
Avista and PPL Lease Litigation	Positive	$8 plus
State Fund Old Fund	Negative	$33 to $150
Wildfire Costs	Negative or Positive	Unknown

Each of the issues listed in Figure 10 could change the general fund balance depending on the timing and resolution of the issue. The following is a brief summary of each issue:

<u>$400 Rebate Reversion</u> – House Bill 9 of the May special session, authorized a $400 property tax rebate for qualifying applicants provided the application was filed on or before December 31, 2007. As of the end of February, there is a $4.2 million appropriation balance. Since the filing date is over two months old, further payments from this appropriation should be minimal. These funds revert to the general fund at the end of the fiscal year.

<u>PPL Protested Tax Settlement</u> – The DOR has reached a negotiated settlement with PPL Montana on the company's protested property taxes for 2003 through 2007. The agreement provides for releasing protested funds to state and local governments and refunding a portion of the taxes to PPL Montana. Since a portion (50 percent) of the state's share of the protested taxes was paid into a protested tax account, the general fund balance will be increased by a transfer from the protested account. Based on calculations from the DOR, the transfer will be $2.3 million in fiscal 2008. Since the revenue estimate for fiscal 2009 assumed PPL Montana would continue to protest their taxes, additional property tax revenues will also be realized in that year also.

<u>Federal Stimulus Package</u> – The "Economic Stimulus Act of 2008" was passed by Congress and signed by President Bush in February, 2008. The primary provisions of the federal tax changes are rebates to individuals and a 50 percent bonus depreciation allowance to businesses for certain types of equipment purchases. Since the rebates will reduce the federal income taxes paid by Montana taxpayers, itemized deductions will be less thereby increasing state individual income taxes. A majority of this positive impact will occur in fiscal 2009. Conversely, the 50 percent bonus depreciation allowance will decrease state revenues. To the extent businesses invest in new equipment and take advantage of the accelerated depreciation, deductions will increase thereby decreasing net income and taxes paid. Negative impacts are expected to occur in fiscal 2009 and 2010 and then be positive for the remaining years of the depreciated asset. The combined impact of the rebates plus the 50 percent bonus depreciation on state revenues is expected to be a small increase for the two year period, fiscal 2009 and 2010. The DOR is currently refining the estimated impacts.

<u>Board of Investments (SIV's) –</u> The state's Short Term Investment Pool (STIP) holds asset backed securities called structured investment vehicles (SIV's). These types of investments are issued by financial institutions and are backed by underlying assets of various types. Some of the assets backing these investments are subprime mortgages and other potentially risky investments. Since the STIP account contains approximately $360 million of SIV instruments, there is concern whether these SIV's may default resulting in loss of principal. The $360 million of SIV's represent approximately 16.5 percent of the investments in STIP. If loss of principal were to occur, the general fund balance, as well as other state funds, would be reduced by its pro-rata share of the loss. The general fund's share of the STIP is approximately 24.2 percent.

Avista and PPL Lease Litigation – Avista and PPL challenged the legality of the state assessing lease payments for the ground under their dams. Avista has settled with the state and has agreed to pay $4.0 million per year in lease payments beginning calendar 2008. These payments are considered distributable income and will be deposited (95 percent) into the public school guarantee account. Five percent will be deposited to the common school trust. Since these monies are used to pay for a portion of public school costs, the general fund portion needed to fund schools will be decreased accordingly. The Avista lease payments will be $8 million in the 2009 biennium. The PPL litigation is still pending before district court.

State Fund Old Fund – Statute requires that funds must be transferred from the general fund to the "old fund" in any fiscal year in which claims for injuries from accidents occurring before July 1, 1990 are not adequately funded. As of June 30, 2007, the estimated old fund liabilities exceeded assets by $32.6 million. Currently, the old fund has sufficient invested assets to meet its obligations until the year 2012. At that time, general fund will be required to offset this shortfall. The $32.6 million unfunded liability is the amount of funds needed at this time, discounted by 5 percent to cover the unfunded liability. The actual costs to the general fund may increase as the claims are paid out in future years.

There is also one pending legal case before the Montana Supreme Court which could significantly impact the old fund and thus, the general fund. The "Satterlee" case is pending before the court on the constitutionality of the statute terminating permanent total benefits when retirement benefits are received. Should the statute be held unconstitutional, and if the statute is applied retroactively, the estimated impact on the old fund and ultimately to the general fund would be between $93 and $116 million.

Wildfire Costs – HB 3, enacted by the September 2007 special legislative session, authorized the transfer of $40.0 million from the general fund to a state special revenue account. The funds in this account are to be used for wildfire costs incurred after June 30, 2008 (fiscal 2009). If all the funds are not used by June 30, 2009, the balance in the account is transferred back to the general fund. For example, if the next wildfire season is close to the historical average of $20 million, then the general fund balance will be increased at the end of the biennium by $20 million – the balance remaining from the $40 million transfer plus interest earnings.

HB 1, enacted by the September 2007 special legislative session, appropriated $42.0 million for the 2007 wildfire season and to restore the Governor's emergency appropriation to $16.0 million. Current estimates of the funds needed are $51.4 million, $9.4 million more than appropriated. If this amount does not change, then the Governor's emergency appropriation will be used to pay the $9.4 million of additional costs. This would leave only $6.6 million left in the emergency appropriation for the remainder of the biennium. Next year's wildfire season and/or other emergencies could exhaust all wildfire funding and the emergency appropriation thereby requiring supplemental funding.

SUMMARY

Based on data through the end of February 2008, total general fund revenue collections for fiscal 2008 have the potential to exceed HJ 2 revenue estimates. While the outlook for most revenue categories has not changed materially since the May special legislative session, the overall trend for general fund revenues for fiscal 2008 is strong. Almost all major sources of revenue are on target or exceeding the estimates contained in HJ 2. The exception is corporation income taxes. Since individual income tax is the predominate source of revenue in the general fund, any shortfall in corporation income taxes and other minor categories (nursing facility fees, insurance taxes, highway patrol fines, coal trust interest earnings) should be easily offset by excess individual income taxes.

The obvious question this report generates is, "What does this information indicate for fiscal 2009 and beyond?" Current trends portray an optimistic outlook for fiscal 2008, but a thorough analysis of the underlying economic conditions is imperative. The housing downturn, high energy and other commodity prices, and the eroding consumer sentiment are all factors that will mold the outlook for future revenue collections. Without this analysis, erroneous conclusions could easily be assumed that may lead to inappropriate fiscal policy during the next legislative session.

This may lead to a “boom and bust” cycle similar to the “dot com” bubble that was followed by a precipitous fall in the equity markets and ultimately a reduction in state revenues in the 2003 biennium.

While your staff will continue to monitor revenue trends, a thorough analysis of current revenue trends with an eye toward the future will be done during the spring and summer in preparation for the revenue estimate process of the Revenue and Transportation Interim Committee (RTIC). This analysis will be the basis for our revenue estimate recommendations to RTIC for the 2011 biennium.